The Concepts and Practice of Risk-Based Supervision

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I. Introduction

Effective Risk Management is the hallmark of a successful financial institution. The success of financial institutions depends on the security, privacy and reliability of services backed by robust operational and effective risk management practices. Effective risk management strategies can be implemented by integrating effective bank-level management, operational supervision and market discipline. The international banking scenario has in recent years witnessed strong trends towards globalization and consolidation of the banking system, stability of the financial system and has become the central challenge to bank regulators and supervisors throughout the world. This has become more apparent in the face of the current financial crisis.

Bank supervisors are facing serious challenges due to greater risk of insolvency of financial institutions. They have realized that any disruption of the financial market or financial system on account of problems associated with a bank or a group of banks would have broader economic consequences. The increased frequency and spread of banking crisis and the resolution cost have prompted bank supervisors to seek an approach which involves identifying potentially problematic institutions and directing supervisory resources to their most efficient allocation.

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The growing complexities of banking business, the introduction of a wider range of products and services and the contagion effects during a banking crisis, have put tremendous pressures on bank supervisors, pushing them to use limited supervisory resources more economically and judiciously. It has, therefore, become necessary to optimize the synergies from different activities, including the regulatory and supervisory functions to enhance the overall efficiency and effectiveness of the supervisory process. This necessitates that the supervisory focus be on individual institutions, which poses more risks rather than having uniform supervisory focus on all institutions. This approach to bank supervision, known as risk-based approach, calls for a thorough assessment of risks faced by banks, which in turn requires the introduction of appropriate risk management systems in banks.

In Nigeria issues bordering on effective risk management by banks have always been a primary concern to regulatory authorities in their bid to entrench and institutionalize safe and sound banking activities. However, recently it has assumed added importance partly due to the fact that over the past decade the banking system has changed dramatically as a result of advances in technology, closer relations among economies, size and speed of financial transactions, liberalization, deregulation and consolidation, among other factors. Another reason is the need to ensure that banks in the country fully comply with the Basel Core Principles on Supervision and to prepare an enabling environment for the implementation of the New Capital Accord.

Essentially, the new capital accord requires banks to adopt stronger risk management practices. The new accord emphasizes maintenance of capital charge against credit risk, market risk and operational risk through adequate capital allocation. While on the one hand, banks will have to adopt proper systems to identify, measure, monitor and control risks, the bank supervisor, on the other hand, needs to set up a process that enables it to determine that banks hold adequate capital against these risks. The bank supervisory authority will thus have dual responsibility. The first is to ensure that no bank is a threat to its supervisory objectives of reducing the vulnerability and maintaining the stability of the entire financial system. The second is that it ensures that the capital standard maintained by a bank is commensurate with the various kinds of risks it faces in its operations. The supervisor will be able to achieve the twin primary objectives only when it has set up a methodology to assess the risks faced by a bank and the extent to which they threaten its supervisory objectives. The required supervisory methodology is Risk-Based Supervision (RBS). RBS seeks to do away with the traditional approach to banking supervision which among other shortcomings is transaction and compliance based, reactive and uniformly applied to all supervised institutions. Also, it does not provide clear yardsticks for risk assessment and allocation of resources in the supervisory processes.

This paper seeks to examine the concept and practice of Risk-Based Supervision. For ease of discussion, the paper has been segmented into five sections. After the introduction, sections 2 and 3 examine the Conceptual Issues in Risk-Based Supervision and Country Experiences. Section 4 looks at the framework of RBS in Nigeria while section 5 concludes the paper.

II.0 Conceptual Issues in Risk-Based Supervision

II.1 Definition of Risk

Any definition of risk is likely to carry an element of subjectivity, depending upon the nature of the risk and to what it is applied. As such there is no all encompassing definition of risk. Chicken & Posner (1998) acknowledge this, and instead provide their interpretation of what a risk constitutes. They see risk as comprising of "hazard" and "exposure". They define hazard as *".. the way in which a thing or situation can cause harm,"* (ibid) and exposure as *".. the extent to which the likely* *recipient of the harm can be influenced by the hazard"* (ibid). Harm is taken to imply injury, damage, loss of performance and finances, whilst exposure imbues the notions of frequency and probability.

The Royal Society (1983) views risk as the probability *"..that a particular adverse event occurs during a stated period of time, or results from a particular challenge.* Smith (1999) defines risk as a decision expressed by a range or possible outcomes with attached probabilities.

In practical terms, risk could be defined as the probability of an adverse event occurring and the impacts of such event on set goals and objectives. Viewed as an integral part of business operations, certain risks and uncertainties such as accidents, fire or theft are insurable, while others like a firm's ability to survive in the face of risks of the market place are not. In such a situation, institutions are expected to evolve risk management strategies to ensure survival and growth.

By the very nature of banking business, banks are inextricably involved in risk - taking. The major risks banks face in the course of business include, but not limited to, credit, market, liquidity, operational, legal and reputational risks. In practice, a bank's business activities present various combinations of these risks, depending on the nature and scope of the particular activity. To the financial sector regulatory and supervisory authorities, what constitute risks are those factors that pose threat or portend danger to the achievement of statutory objectives. Generally, these objectives include the promotion of a stable, safe and sound financial system, ensuring an efficient payment system, necessary for the achievement of the wider economic objective of welfare improvement, ensuring effective consumer protection and the reduction of financial crimes, among others.

The attainment of these objectives informs the need to put in place a supervisory framework, which takes different forms as dictated by the size, level, and sophistication of an economy's financial sector, market developments and supervisory capabilities.

II.2 Risk Based Supervision (RBS)

II.2.1 Historical Brief on RBS

Risk-based supervision was conceptualized by the United States of America (USA) Office of Comptroller of Currency (OCC) in the early 1980s. Before 1970s, the US banking system was characterized by narrow scope of products and services and market volatility was minimal. During that period, banks needed not worry about formal rigorous framework for risk management neither would supervisors need worry much about bank risk monitoring as concern was mainly for primary risks of financial intermediation. By 1970s and 1980s, banks had been characterized by greater market volatility and the emergence of secondary and obscure risks which accounted for significant losses. The inadequacy of the traditional methods of risk assessment and even bank supervision then became more apparent than hitherto. With the above developments, a meeting of Senior Bank Examiners in San Francisco in 1980 arrived at the following major decisions:

- Examiners should relate results of examinations to bank's risk exposure
- Focus on risks that can have the most adverse impact on capital, liquidity, compliance and future of the institution
- Focus on areas with highest risks.

That marked the introduction of risk-based supervision.

By the early 1990s, the face of banking in America and other parts of the world began to change with:

- Consolidation and expansion of banking business

- Financial innovation
- Spread of new financial instruments like derivatives, swaps etc
- Change in banking business
- Computer, telecoms and satellite technologies opening avenues for intermediation and risk management

Also, along with financial innovation, risk management systems began to evolve due to advances in Information Technology, while more sophisticated risk management systems gave banks a more accurate view of their risk-adjusted returns on capital.

With the above developments coupled with the savings and loan debacle of the US in the 1990s, some lessons, which touched on the type of RBS introduced in the 1980s, were learned. Some of these lessons included:

- There was greater regulatory appreciation of systemic risks and effects;
- Need to recognize the effect of the economic environment on individual institutions and banking system as a whole; and
- Appreciation of the importance of evaluating how well financial institutions are managed as well as the importance of evaluating their risk management systems.

Following from the foregoing and given the complexities of banking business and emerging product innovations with complex risk profiles, a more robust RBS framework emerged and the principle of RBS in general witnessed a growing acceptance as a more efficient supervisory approach than the traditional transaction-based approach.

Risk-Based Supervision (RBS) is a proactive and efficient supervisory process, which focuses attention on the risk profile of the supervised financial institutions and enables bank supervisor to develop a supervisory package for each bank, efficiently allocate resources based on the risk profile of individual banks and proactively monitor and supervise banks to facilitate the attainment of the supervisory objective of promoting the soundness, safety and stability of the financial system. By placing premium on risk mitigation rather than risk avoidance, RBS seeks to encourage each bank to develop and continuously update its internal risk management systems to ensure that it is commensurate with the scope and complexity of its operations. The approach is expected to optimize utilisation of supervisory resources and minimize the impact of crisis situation in the financial system.

It is important to recognize that there is no international consensus on the concept of a risk-based supervision approach, but, there are some generic features which include the following:

- comprehensive/detailed assessment of the risk profile of the bank overall assessment score/rating;
- assessment of qualitative/quantitative risk factors and risk management oversight functions;
- identification of significant activities of the banking institution; and
- assessment of the inherent risks of each significant activity.

In general, therefore, the basic approach to risk-based supervision is to differentiate banks in accordance with their risk profiles so that supervisory resources could be diverted on priority basis to those areas or banks which threaten their solvency and hence, the supervisory objectives. Risk-based supervision will, therefore, begin with the compilation of risk profile of a bank and the thrust of supervision will be on the examination of systems and procedures for risk management and risk control by banks. The transition to risk-based supervision system requires self-assessment of risks by the banks themselves and adoption of statistical models for risk quantification and submission of the document on Self-Assessed Risk Profile and the Risk

Management Process to the Supervisory Authorities.

The main objective of risk-based supervision is to sharpen supervisory focus on the following, among others:

i) the activity(ies) or institution(s) that pose the greatest risk to banks and financial institutions and/or financial system; and

ii) the assessment of management process to identify, measure, monitor and control risks.

II.2.2 Traditional Approach versus RBS

Traditional supervision procedures put reliance on transaction testing such as evaluating the adequacy of the credit administration process, assessing the loans' quality and ensuring the adequacy of provisioning for loan losses, and so on. By reviewing and testing individual transactions, the examiners are not looking at the 'true' business of banking - that of taking risks. Evaluating the risks enables the regulator gain a better understanding of how the institution operates and the potential input on its financial condition of entering into a transaction.

For transaction testing, examiners usually use the same techniques and methods for all banks they inspect. This one-size-fits-all approach to supervision has been observed to be inefficient and untenable in a situation where banks vary in terms of size, business mix and appetite for risk. Even among the largest banks, no two banks have exactly the same risk profiles or risk controls. Hence, the methodology and approach to supervision must be customized for each bank; the more complex a bank's business activity, the more sophisticated must be the approach to on-site inspections.

Traditional supervision focuses more on quantifying problems and minimising risks in individual banks. It results in quantifying problems, correcting symptoms of problems, and instructing banks to avoid risks. In cases where problems are quantified, the supervisory response is usually to take actions directed towards reducing the size of the problem. The trouble with this approach is that it usually addresses only the symptoms of the problem, without addressing its causes.

On the other hand, risk-based supervisory approach essentially entails the allocation of supervisory attention in accordance with the risk profile of each institution. Risk-based supervision requires a greater understanding of the institution being supervised and of the environment in which it operates. It requires an understanding of the institution's risk profile, in order to identify areas of greatest risk. Table 1 summarizes the differences between RBS and traditional approach to supervision.

Table 1: Difference Between RBS And Traditional Approach to Supervision

TRADITIONAL	RBS
Traditional supervision often results in: - quantifying problems - correcting symptoms of problems, and - instructing banks to avoid risks that seem too high	• Risk-based supervision assesses the quality of risk management practices, • It addresses causes of problems, and • It makes recommendations that give banks options on how to minimize the adverse consequences of risk-taking
It is transaction-oriented and usually more labour intensive than risk-based supervision thereby straining the scarce resources of most regulators.	• It assigns the highest priority to areas of highest risk • Management of those areas is evaluated, along with systems designed to optimize income while managing risk and minimizing the adverse consequences of risk-taking.
• Rather Reactive	• Quite Pro-active

In summary therefore, The main benefits of RBS to supervision include amongst others:

i) The allocation of supervisory resources according to perceived risk, i.e. focusing resources on the bank's highest risk or devoting more supervisory efforts to those banks that have a high-risk profile. It will, therefore, enable the regulator to target and prioritise the use of available resources.

ii) The supervisor will be better placed to decide on the intensity of future supervision and the amount and focus of supervisory action in accordance with the perceived risk profile of the bank.

iii) The supervisor may also focus more attention on banks whose failure could precipitate systemic crisis.

111 Country Experiences

In this section, we shall examine the practice of RBS in a number of jurisdictions, namely: USA, Canada, Hong Kong, Singapore, United Kingdom (UK) and India. For ease of understanding, the discussion is presented under two broad groups, namely: RBS in Group A consisting of US, Canada, Hong Kong and Singapore and the RBS in Group B made up of UK and India. The broad categorization is based on the fact that the RBS frameworks of countries in each group have similar features although they may differ in details.

III.1 RBS in Group A

The RBS frameworks of the Federal Reserves and OCC in the US, the Office of the Superintendent of Financial Institutions (OSFI) in Canada, Hong Kong Monetary Authorities and the Singapore Monetary Authorities have a seven-step business line approach as follows:

i) *Identifying the significant activities in the bank.*

The first step is to identify the significant activities which are regarded as those lines of business or units such as treasury or credit operations, which impact on the achievement of the strategic objectives of the financial institutions. These activities include any significant line of business, unit (including. subsidiary) or process which can be in terms of their contribution to income, expenditure or their effects on the operations of the bank.

ii) *Assessing the inherent risks in the significant activities and developing a* risk *matrix.*

After the identification of significant activities, the next step is to ascertain the risks inherent in the activities. This takes the form of risk matrix which defines the level of inherent risk in all the significant/functional activities. For instance, in an activity such as commercial lending, the credit risk can be moderate; market risk can be low, while operational risk can be high.

iii) *Examining the quality of the* risk *management in the bank.*

Under the risk-based supervision system, risk management adopted by a bank would be evaluated by the Supervisor to verify whether all risks are captured by the institutions, whether the process is adequate to identify, measure, monitor and control all risks and whether the institutions have taken risk mitigation steps in time as warranted by the situation.

The assessment of the quality of a bank's risk management system entails the examination of board and management oversight, policies, procedures and limits, internal audit, compliance, financial analysis, etc. All these activities serve as risk mitigating factors. A composite or net risk is then determined. This can be low, moderate or high for a bank. The direction of the composite risk is equally very important, i.e. the risk could be rising, declining or stable in succeeding periods.

iv) *Planning and Scheduling Supervisory Activities.*

The supervisory plan represents a bridge between the institution's risk assessment, which identifies significant risks and supervisory concerns and the supervisory activities to be conducted.

v) *Defining Examination Activities.*

This involves defining the scope of the examination. This entails the specification of activities of interest as well as specific information on the identified activities required by the examiner/supervisor from the bank.

vi) *Performing Examination Procedure.*

Having performed the risk assessment and developed a scope memorandum for the examination of a bank, examination procedure is tailored to the characteristics of each bank, keeping in mind size, complexity and risk profile.

vii) *Writing the Report.*

The report is the final product of any examination process. It communicates, in a clear and concise manner, to the management of the bank, any supervisory issue, problems or concerns relating to the bank.

The basic risk focus of all the frameworks are mainly credit, market, liquidity, operational, legal and reputational. There are, however, some differences reflecting the different experiences of jurisdictions and/or regulatory authorities in those jurisdictions. Hence, in some of the jurisdictions, market risk has been further broken down to interest rate, price and foreign currency translation risks as in the case of Office of Comptroller of Currency (OCC). The OCC and Hong Kong Monetary Authorities and OSFI and Nigeria have added strategic risk to the list of their risks of focus while OSFI framework has also recognized regulatory risks similar to the compliance risk recognized by OCC.

Furthermore, the framework of Singapore Monetary Authorities adopts an approach that is articulated through the impact and risk model. The RBS framework in this jurisdiction first evaluates and rates the impact of an institution relative to other institutions. It then employs a risk assessment system to evaluate the risk of an institution. It then combines the assessments of both impact and risk ratings and distinguishes those institutions that may pose a higher threat to the achievement of its respective supervisory objectives. Finally, it determines the appropriate supervisory strategies and, in turn, the level of supervisory intensity required.

III.2 RBS in Group B

The RBS frameworks of the Financial Services Authority (FSA) of the UK and that of the Reserve Bank of India have a six-step approach. The steps are briefly described below:

i) Preparing for the risk assessment:

The supervisory priority given to a particular risk depends on two factors, namely: impact of the risk when it materializes and the probability of the risk materializing. The first step, therefore, is to assess the impact of financial institution using quantitative information previously supplied by the institution as part of its regulatory reporting against the supervisor's metrics of impact threshold. The metrics are used to score an institution as having high, medium or low impact. All institutions other than those designated as having low impact would be subjected to individual risk assessment.

ii) Bank Specific Risk Assessment:

At this stage, the focus is to assess the likelihood of various bank-specific risks crystallizing. In achieving this, the first step is to identify the risk elements that threaten the achievement of the supervisory objectives. Banks will be assessed based on a risk map, which takes into account external events or threats (environmental risks) and bank-specific risk (business and control risk) issues and scores each of these risks in a common way.

Environmental risks include political/legal, socio-demographic, technological, economic, competition and market structure while institution's specific risks are business and control risks. Business risks are derived from the overall philosophy of the bank and include issues of strategy, target market, products and services, and the risk attached to the financial soundness of the institution. These risks include strategy, market, credit, operational, legal and liquidity, among others. Control risks are the risks arising from the failure and/or inadequacies of systems, processes and procedures as well as organisation and culture. Such risks include those arising from customer treatment, internal systems and controls, board and management oversight and business compliance culture.

The risk assessment techniques adopted by bank supervisors could vary depending on the structure of the financial system, the volume and complexity of operations and the extent of reliance the Supervisor would like to place on the integrity of data and information supplied by banks. The track record and credibility of a bank are important, as the time required to complete the risk assessment process would depend on the availability of the range and quality of data and information supplied by banks. The overall risk assessment of a bank involves a detailed assessment of business risks and control risks. The assessment should reveal the level of risks assumed by the bank in its various operations, the risk it poses to the financial system and the supervisory objectives. From the supervisor's perspective, the process involves a detailed and structured assessment of the inherent business risks, the adequacy and effectiveness of controls, the organizational structure to manage the risks and the management initiatives to address the risks. The assessment should reveal the strengths and weaknesses in various areas of a bank's operations, the potential problems that exist and are likely to arise in the near future and the direction of the risk level.

In order to arrive at the overall risk profile of a bank as well as to rank the banks in order of the gravity and seriousness of risks for timely supervisory intervention, it is necessary to prescribe the scale for risk rating and the minimum score for each scale to maintain the objectivity and uniformity in assignment of risk level. The practices vary between Bank Supervisors from a four-scale rating (low, medium, fair and high) to a three-scale rating (low, moderate and high). The corresponding numerical score could be 1(low), 2(moderate), 3(fair) and 4(high). The methodology involves, first to arrive at the total business risk and assign a rating to it in the light of the assessment made, and then to arrive at the total control risk and assign to it and finally to map the business risk and control into a risk matrix to arrive at the overall risk as given below:

The composite risk of a bank is determined by the product of impact of risk and the probability of risk.

iii) Development of a risk mitigation programme:

Risk Mitigation Programmes (RMP) are programmes of regulatory actions designed to be outcome-oriented. Tools employed include diagnostic, monitoring, preventive and remedial tools. Diagnostic tools are those to identify, assess and measure risks. Monitoring tools are those designed to track the development of identified risks, wherever these arise. Preventive tools are designed to limit or reduce identified risks and so prevent them crystallizing or increasing. Remedial tools are designed to respond to risks when they have crystallized. Risks viewed as high or medium, especially on the control side, would require mitigating actions by the institution or the supervisory authorities or both and would normally involve preventive or remedial tools. High impact institutions would require additional elements of the RMP to identify changes to the risk profile, such as emerging risks within business units and adequacy of an institution's senior management and control structure.

iv) Internal Validation:

This is a quality and consistency control review process that provides a challenge mechanism to the supervisory team. It helps in making sector comparisons of risks and checks the appropriateness of risk mitigating programme.

v) Communicating the results of the assessment to the financial institution:

This means sending the results of the supervisor's assessment to an institution in a letter. It sets out the supervisor's view of the risks posed by an institution together with the RMP that sets out the actions to be taken by the institution and the supervisory authorities to address the issues raised.

vi) On-going Assessment and Response to Risk Escalation:

An interim review of an institution is conducted to ascertain if the regulatory period is longer than 12 months. The review employs a desk-based assessment and identifies any material changes to the probability assessment or risk mitigation programme. The institution keeps the supervisors informed of significant events that may affect risk assessment. Such events include, but not limited to, failure in an institution's systems or controls, development of new types of products or services, significant breach of a rule and fraud against a customer.

In order to make effective the phased implementation of its RBS framework introduced in 2002/2003, the Reserve Bank of India put forward some bank-level preparations. These included the adoption of risk-focused internal audit, strengthening MIS and IT, addressing HR issues, setting up a compliance unit in each bank. In the case of risk-focused internal audit, a bank's internal auditor would have to capture the application and effectiveness of risk-management and assessment procedures, and critical evaluation of the adequacy and effectiveness of the internal control systems. To achieve these objectives, banks were encouraged to gradually move towards risk-focused auditing, in addition to selective transaction-based auditing. The implementation of risk-based auditing means greater emphasis is placed on the internal auditor's role of mitigating risks. By focusing on effective risk management, the internal auditor will not only offer remedies for current trouble areas, but also anticipate problems and protect the bank from risk hazards.

III.3 Examination Cycle

The examination cycle for each bank under any of the two broadly described frameworks varies, depending on the materiality of the risk profile of a bank. However, more frequent assessments are resorted to for higher risk banks and less frequent assessment for lower risk banks.

IV.0 The Nigerian RBS Framework[1]

The Nigerian RBS Framework which adopts a 'hybrid approach', embraces the features of frameworks similar to those described in Group A. However, at the commencement of the implementation of the Risk-Based Framework, there will be a full-scale maiden examination.

The stages of the framework are as follows:

Stage 1: full scope maiden examination of banks

A full scope examination will be conducted at the commencement of the risk-

[1] *Nigeria is yet to implement RBS but it has developed a framework.*

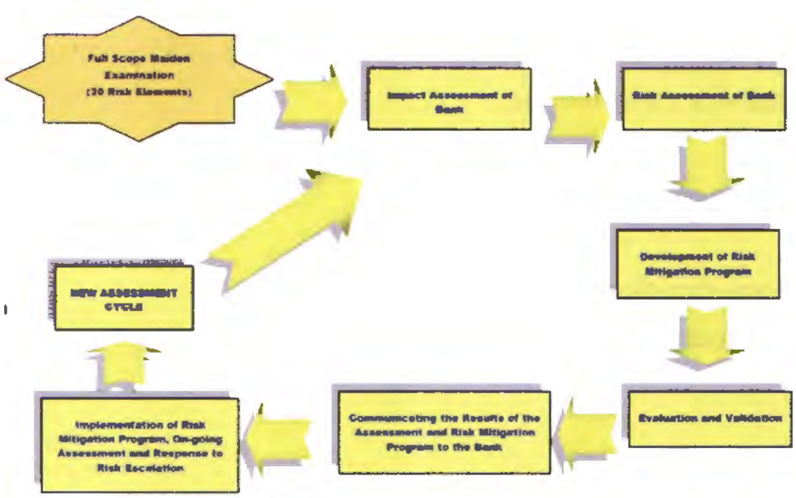
based supervisory process. This stage will be a one-off event, as subsequent examinations will depend on the supervisors' assessment and perception of the risks of individual banks.

Stage 2: impact assessment

The first step at this stage is to determine the potential impact of a bank, in the event of distress, on the entire financial system by appraising quantitatively, balance sheet items such as total assets and deposits against defined **impact thresholds**. This will indicate the scale and significance of the problem if it were to occur. The bank will then be categorized into impact bands - High, Medium and Low.

Stage 3: the risk assessment of banks

At this stage, the focus is to assess the likelihood of various bank-specific risks crystallizing. In achieving this, the first step is to identify banks' significant activities and the inherent risks associated with those activities. This will involve the identification/determination of the core business areas of the bank from the general businesses of banking, which typically include:



- Deposit Mobilization
- Assets creation; and
- Fee-based activities.

The process will also involve the recognition of other activities which support the core activities, such as IT, Operations & Risk Management, Corporate & Management Services, Internal Control, Strategy and Systems, etc.

The level of income and expenditure associated with a particular business area and/or unit (including subsidiaries) of the bank would constitute a basis for determining the significance of an activity. It is important to note that significant activities are bank-specific as what is considered significant in one bank may be insignificant in another and vice versa.

Having identified the significant activities, the next stage is to determine the specific risks inherent in those activities. In that regard, the focus will be on the following observed common 6 risk elements in our jurisdiction, strategy, credit, market, operational, liquidity and legal risks.

Stage 4: development of risk mitigation programme

The risk mitigation programmes (RMPs) are regulatory actions designed to address the issues identified at the risk assessment stage. The programme will address the nature of the risk, intended outcome, actions to be taken by the supervisor and/or the bank and the timeframe within which to implement the programme. This will involve the selection of regulatory tools, based on the severity and nature of the risk and the expected outcome. They consist of actions to be taken either by the supervisor or the bank and are classified under four broad groups as shown in Table 2.

Table 2: Supervisory Tools

Diagnostic	Monitoring	Preventive	Remedial
• On-site examinations • Investigations • Sector-wide projects • Risk assessments	• Off-site surveillance • On-site visits • External auditors	• Disclosure • Consumer education • Public statements • Regulatory standards • Authorisations • Institution-specific standards • Contingency planning • Self Regulatory Organisations (SRO) • Memoranda of Understanding (MOU)	• Compensation schemes • Complaints resolution • Holding actions • Disciplinary actions • Interventions • Restitution • Penalties

The diagnostic tools will be used mostly to identify and/or measure risks, the monitoring tools will be used to keep track of risks on an on-going basis, the preventive tools are meant to mitigate or reduce risks while the remedial tools will be used to address crystallised risks.

The selection of regulatory tools will depend on the overall risk rating of the bank. For banks rated High, remedial and preventive tools will mainly be applied; for those rated Medium, monitoring and preventive tools will be applied; while for those rated Low, diagnostic and monitoring tools will mainly be applied.

Stage 5: evaluation and validation

Having completed the risk assessment and the risk mitigation programme, the next stage entails conducting an internal evaluation and validation, before the results are adopted for implementation. The validation and testing process is expected to provide quality control and ensure consistency. A committee whose members will be independent of the risk assessment team of a particular bank and/or the Head of the relevant Supervisory Department, as the case may be, will conduct it.

Stage 6: communicating the results of the assessment and risk mitigation programme to the bank

The results of the risk assessment, the threat it poses to the institution and the system, the on-site examination report and the risk mitigation programme, will be formally communicated to the bank.

The letter communicating the result of the risk assessment will contain the following:

i) The significant activities of the bank.
ii) Key findings that lead to the bank-specific risk scores of "High", "Medium" or "Low".
iii) The composite risk rating.
iv) The direction of the composite risk rating
v) The overall composite risk rating.
vi) The length of the regulatory period.
vii) A requirement that the bank should, at all times, communicate significant events that may affect the risk assessment to the supervisors.

The letter also, will include findings of on-site visit, which should contain the following:

i) The supervisor's view of key environmental or external risks facing the bank (where appropriate) that provides the context for the bank-specific issues identified in the risk assessment.
ii) The detailed comments and observations of the Examiner.

Finally, the letter will also inform the bank of the prescribed risk mitigation programme that will set out the following:

i) The issues identified by the supervisors.

ii) The intended outcome the supervisors seek to achieve for each issue.

iii) The action to be taken to achieve the intended outcome, specifying whether the action is to be taken by the supervisor or the bank.

iv) The timetable of the action.

Stage 7: the implementation of the risk mitigation programme, on-going assessment of the bank and response to risk escalation.

Where a bank's supervisory period exceeds 12 months, an interim review will be carried out before the expiration of the regulatory period to determine whether the earlier risk assessment and risk mitigation programme are still applicable to the bank. The review will also determine whether there has been an escalation of the risks and the appropriateness of the risk mitigation programme. The review will be an off-site assessment, covering all the risk factors, issues and the supervisory tools deployed.

Reviews could also be carried out when any of the following occurs:

i) Developments in the external environment that could materially affect the bank.

ii) Changes in the bank's business, strategy, infrastructure or management.

iii) Where the supervisory tools deployed have not been effective.

iv) Successful achievement of desired outcomes in the RMP, which should ordinarily lead to an improvement in the risk profile of the bank.

V.0 Conclusion

Financial institutions are becoming more complex and internationally active, markets are more volatile and interconnected. Increasing globalization can bring many benefits; but as recent events illustrate, the costs of financial instability are also rising. In response to this environment, many supervisors are adopting a risk-based framework. They are moving away from a rigid, rules-based style of regulation to one more reliant on the supervisor's discretion and professional judgment. The new Basel II capital accord and pillar two in particular, is only the most obvious manifestation of this new trend. However, while risk-based supervision holds out the hope of a more flexible and targeted regime which can adapt to fast changing market developments, it also puts renewed pressure on front-line supervisors.

The effectiveness of the RBS would clearly depend on banks' preparedness in certain critical areas, such as quality and reliability of data, soundness of systems and technology, appropriateness of risk control mechanism, supporting human resources and organizational back-up.

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